

## Message Text

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ACTION EUR-12

INFO OCT-01 ISO-00 AID-05 CIAE-00 COME-00 EB-08 FRB-03  
INR-10 NSAE-00 ICA-11 TRSE-00 XMB-02 OPIC-03  
SP-02 LAB-04 SIL-01 OMB-01 NSC-05 SS-15 STR-07  
CEA-01 L-03 H-01 PA-01 ABF-01 IO-13 /110 W  
-----121610 131506Z /42

P R 131227Z APR 78  
FM AMEMBASSY LISBON  
TO SECSTATE WASHDC PRIORITY 5420  
INFO AMEMBASSY BONN

C O N F I D E N T I A L SECTION 1 OF 2 LISBON 2794

DEPT ALSO PASS TREASURY FOR SYVRUD

E.O. 11652: XGDS-3  
TAGS: ECON, EFIN, PO  
SUBJECT: PORTUGAL-IMF NEGOTIATIONS

SUMMARY: ECON COUNSELOR REVIEWED REF SUBJECT WITH FINANCE MINISTER CONSTANCIO ON APRIL 11. LATTER REPORTED THAT THE GOP EXPECTED TO COMPLETE ITS INITIAL PRESENTATION TO IMF MISSION THAT AFTERNOON. ADDRESSING MAJOR ISSUES UNDER DISCUSSION, CONSTANCIO STATED THAT HE COULD ACCEPT SIGNIFICANT ESCUDO DEVALUATION, BUT ONLY AS FAST CRAWL NOT AS A PERCENTAGE POINTS IN BANK OF PORTUGAL REDISCOUNT RATE AND AN AVERAGE RISE OF THREE POINTS IN MARKET RATES, BUT A SEVEN-POINT INCREASE AS PROPOSED BY THE FUND WOULD CAUSE SERIOUS DOMESTIC PROBLEMS; AND HE WAS PREPARED TO MOVE SIGNIFICANTLY CLOSER TO THE FUND'S RECOMMENDED CREDIT EXPANSION CEILING. RESULTS FOR THE FIRST QUARTER 1978 INDICATE THAT PRESENT TREND WOULD LEAD TO LARGER EXTERNAL DEFICITS THAN GOP AND IMF HAD SET, IN PRINCIPLE, AS TARGETS FOR CY 1978 AND PROGRAM YEAR APRIL 78-MARCH 79. DESPITE DOMESTIC RESISTANCE, CONSTANCIO IS PREPARED TO ADOPT THE CORRECTIVE ECONOMIC MEASURES. HE CANNOT, HOWEVER, ACCEPT THE FUND'S  
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RECOMMENDATIONS FOR A SIGNIFICANT DISCRETE DEVALUATION AND A SEVEN-POINT RISE IN INTEREST RATES. END SUMMARY.

1. ECON COUNSELOR REVIEWED REF SUBJECT WITH FINANCE MINISTER CONSTANCIO ON APRIL 11. LATTER REPORTED THAT IMF MISSION HAS NOT YET SPECIFIED ITS POSITION ON THE MAJOR ISSUES UNDER DISCUSSION. IN LARGE PART, THE FUND'S RELUCTANCE TO

EXPRESS ITSELF UNDOUBTEDLY STEMS FROM GOP DELAY IN COMPLETING EXPLANATION OF ITS OPENING POSITION. HE ADMITTED THAT GOP, FOR LACK OF COMPLETE DATA ON FOREIGN ASSETS, HAD NOT MOVED AS RAPIDLY AS IT MIGHT HAVE DESIRED. HE EXPECTED, HOWEVER, THAT GOP WOULD COMPLETE ITS PRESENTATION THE AFTERNOON OF APRIL 11. ASKED IF HE BELIEVED THE FUND MISSION WOULD REMAIN IN PORTUGAL TO CONTINUE DISCUSSIONS, CONSTANCIO REPLIED THAT HE HAD NO REASON TO THINK OTHERWISE.

2. THE MINISTER DESCRIBED GOP POSITIONS, AND PARTIAL FUND REACTION THERETO, ON FOLLOWING MAJOR ISSUES:

A. EXCHANGE RATE - CONSTANCIO SAID HE COULD NOT ACCEPT A SIGNIFICANT DISCRETE DEVALUATION, PARTICULARLY SINCE NEITHER HE NOR THE FUND BELIEVED THAT SUCH A MOVE WOULD PRODUCE MAJOR IMMEDIATE B/P BENEFITS. HE FEELS ANNOUNCEMENT OF A SIGNIFICANT DEVALUATION, ESPECIALLY FOLLOWING RECENT PRICES RISES, WOULD BOOST INFLATION PRESSURES TREMENDOUSLY. OBSERVING THAT ESCUDO HAD DEPRECIATED THREE PERCENT DURING MARCH, ON A TRADE WEIGHTED BASIS, CONSTANCIO AFFIRMED THAT HE WAS PREPARED TO ALLOW A RAPID CRAWL THAT WOULD FURTHER DEPRECIATE THE ESCUDO BY SIX OR SEVEN PERCENTAGE POINTS IN ONE MONTH. FUND MISSION, HE CLAIMED, IS PRESSING NOT ONLY FOR A DISCRETE DEVALUATION, BUT ALSO ONE THAT WOULD DEVALUE THE ESCUDO AGAINST THE DOLLAR RATHER THAN MERELY AGAINST A TRADE WEIGHTED CURRENCY BASKET. CONSTANCIO DESCRIBED THIS PROPOSAL AS A CHANGE IN THE FUND POSITION, BUT ADMITTED THAT HE COULD

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IMPLEMENT IT IN THE FORM OF A CRAWL. HE WOULD EXPLAIN THE MOVE AS A ONE-TIME CORRECTIVE ADJUSTMENT, COMPENSATING FOR THE ESCUDO'S RECENT FAILURE TO DEPRECIATE RELATIVE TO THE DOLLAR, AND WOULD REITERATE GOP INTENTION TO CONTINUE THE PRESENT SLOW CRAWL POLICY. (CONSTANCIO CLEARLY UNDERSTANDS THAT THE FUND EXPECTS THE DOLLAR TO CONTINUE DEPRECIATING RELATIVE TO SEVERAL MAJOR CURRENCIES AND, THEREFORE, THAT AN ESCUDO SLIDE AGAINST THE DOLLAR IMPLIES AN EVEN LARGER DEPRECIATION VIS-A-VIS THOSE CURRENCIES.) CONSTANCIO MAINTAINED THAT SUCH A PROCEDURE, I.E., AN INITIAL FAST CRAWL OF SIX TO SEVEN PERCENTAGE POINTS IN ONE MONTH AND A SUBSEQUENT SLOWER CRAWL, WOULD GIVE DESIRED SIGNAL TO FINANCIAL MARKETS WITHOUT SPARKING A MASSIVE, GENERALIZED PRICE RISE.

B. INTEREST RATES - THE MINISTER REJECTED A SEVEN PERCENTAGE POINT RISE IN INTEREST RATES. CITING THIS POINT AS ANOTHER INDICATION THAT THE FUND HAS HARDENED ITS POSITION SINCE LAST NOVEMBER, WHEN IT PROPOSED A FIVE POINT RISE, HE STATED THAT HE IS PREPARED TO INCREASE THE BANK OF PORTUGAL DISCOUNT RATE BY FOUR POINTS AND MARKET RATES BY AN AVERAGE OF THREE POINTS. A LARGER INCREASE, HE ASSERTED, WOULD AROUSE VERY SEVERE RESISTANCE FROM INDUSTRIALISTS AND HOME BUYERS, PERHAPS ENOUGH TO CAUSE SERIOUS SOCIAL/POLITICAL

PROBLEMS.

C. CREDIT CEILING - CONSTANCIO WAS SURPRISINGLY RELAXED IN DISCUSSING CREDIT CEILINGS. HE STATED THAT HE COULD ACCEPT AN EXPANSION CEILING OF 130 BILLION ESCUDOS, BUT HAS NOT TRANSMITTED THIS LOWER FIGURE TO THE FUND MISSION. (GOP HAD PREVIOUSLY INSISTED ON A MINIMUM EXPANSION OF

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CEA-01 L-03 H-01 PA-01 ABF-01 IO-13 /110 W  
-----122339 131506Z /42

P R 131227Z APR 78  
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TO SECSTATE WASHDC PRIORITY 5421  
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135 BILLION ESCUDOS.) REMINDED THAT THE FUND'S PROPOSAL IS STILL SUBSTANTIALLY LOWER THAN 130 BILLION, HE CONFIDENTLY STATED THAT THIS DIFFERENCE WOULD CAUSE NO SERIOUS PROBLEM. HE EVEN CLAIMED THAT REACHING AGREEMENT ON THIS POINT WOULD BE RELATIVELY EASY, IMPLYING THEREBY THAT HE WAS DISPOSED TO MOVE FURTHER TOWARD THE FUND'S POSITION. CONSTANCIO EVIDENTLY WAS SIGNALING HIS ACCEPTANCE OF TIGHT CREDIT AS A CRUCIAL, AND PERHAPS HIS PRINCIPAL, TOOL FOR RESTRICTING DOMESTIC DEMANDS AND REDUCING IMPORTS.

3. THE MINISTER OBSERVED THAT PORTUGAL'S B/P DEFICIT DURING THE FIRST QUARTER, WHILE BETTER THAN IN THE SAME PERIOD OF 1977, WAS UNACCEPTABLY HIGH. PRELIMINARY GLOBAL RESULTS FOR JAN - FEB AND BANK OF PORTUGAL ACCOUNTS FOR MARCH INDICATE THAT THE FIRST QUARTER DEFICIT APPROXIMATED 290 MILLION DOLLARS, OR SUBSTANTIALLY LESS THAN THE 440 MILLION DOLLARS OF FIRST QUARTER 1977. THESE RESULTS SUGGEST THAT THE CURRENT ACCOUNT DEFICIT IS TENDING TO EXCEED THE ONE BILLION DOLLAR TARGET SET BY THE GOP AND IMF FOR CY 1978. THE PRESENT TREND, MOREOVER, WOULD LIKELY PRECLUDE PORTUGAL'S ACHIEVING THE CURRENT ACCOUNT DEFICIT

TARGET OF 900 MILLION DOLLARS ACCEPTED IN PRINCIPAL FOR  
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A PROGRAM YEAR APRIL 78 - MARCH 79. THUS, CONSTANCIO  
AFFIRMED, GOP MUST IMPLEMENT MORE EFFECTIVE MEASURES,  
NOTABLY TIGHTER CREDIT LIMITATIONS.

4. CURRENT POLITICAL SITUATION, CONSTANCIO LAMENTED,  
DOES NOT FAVOR ADOPTION OF SEVERELY RESTRICTIVE ECONOMIC  
MEASURES. SA CARNEIRO'S CAMPAIGN AGAINST THE POLITICAL  
SYSTEM AND HIS APPEAL TO THE EXTREME RIGHT HAVE SERIOUSLY  
DISTURBED THE DOMESTIC SCENE. THE CENTER DEMOCRATS (CDS),  
FEARFUL OF A DETERIORATION IN THEIR PUBLIC IMAGE, HAVE  
GROWN WARY OF AN IMF AGREEMENT THAT PROMISES TO AROUSE  
PUBLIC DISCONTENT. CDS PRESIDENT FREITAS DO AMARAL'S  
STATEMENTS UPON HIS RETURN FROM GERMANY LAST WEEK,  
THAT PORTUGAL MIGHT BE ABLE TO FIND AN ALTERNATIVE TO  
THE IMF SOLUTION, REFLECTS THIS GROWING HESITANCY.

5. DESPITE THESE DOMESTIC POLITICAL CONCERNS, CONSTANCIO  
ACKNOWLEDGED THAT AN AGREEMENT WITH THE FUND IS  
ESSENTIAL. PRIME MINISTER SOARES REPORTEDLY SUPPORTS  
THIS POSITION COMPLETELY. CONSTANCIO CONCEDED THAT  
MUCH OF HIS OWN PUBLIC STATEMENTS (LISBON 2683), WHILE  
TRUE IN PART, WAS PUBLIC POSTURING. HE FULLY APPRECIATES,  
FOR EXAMPLE, THAT THE MUCH DISCUSSED MINI-MARSHALL PLAN  
CAN BE ONLY A PROGRAM THAT FOLLOWS, NOT REPLACES, AN  
IMF ARRANGEMENT. HOWEVER, THE IMF AGREEMENT  
TERMS, WHICH THE GOP PLANS TO MAKE KNOWN BY PUBLISHING  
ITS LETTER OF INTENT, SHOULD PROVIDE MAXIMUM FLEXIBILITY  
FOR ADJUSTING TO FUTURE DEVELOPMENTS. CONSTANCIO  
FLATLY STATED THAT HE COULD NOT BE RESPONSIBLE FOR  
ACCEPTING TERMS THAT PROVIDE FOR A SIGNIFICANT DISCRETE  
DEVALUATION OR A SEVEN POINT INCREASE IN INTEREST  
RATES. HIS DOMESTIC POLITICAL STATURE, HE FEELS, IS  
NOT LARGE ENOUGH FOR HIM TO DO SO, AND HE REFUSES TO  
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BECOME A SCAPEGOAT FOR ALL THE CRITICISM THAT WOULD  
FOLLOW IMPLEMENTATION OF SUCH POLICIES. SHOULD THE  
FUND INSIST ON SUCH TERMS, HE MIGHT WELL GO TO  
WASHINGTON TO PLEAD HIS CASE. IF THE TRIP WERE  
UNPRODUCTIVE, WHICH APPEARS LIKELY, HE WOULD FEEL  
OBLIGED TO RESIGN HIS POSITION.

6. COMMENT: THE ABOVE CONVERSATION RECONFIRMED THAT

GOP ASSUMES IT WILL CONCLUDE A SECOND TRANCHE AGREEMENT, EVEN THOUGH TERMS OF THE AGREEMENT STILL MUST BE RESOLVED. RECENT PUBLIC STATEMENTS BY GOP OFFICIALS, SOMETIMES SUGGESTING VAGUE POSSIBILITY OF AN ALTERNATIVE OPTION, SEEK LARGELY TO CONVINCE DOMESTIC OPINION THAT GOP IS PRESSING FOR BEST POSSIBLE TERMS. DESPITE PRESS SUGGESTIONS THAT GOP AND IMF MAY HAVE REACHED AN IMPASSE, THEY APPARENTLY HAVE NOT EVEN BEGUN A GENUINE SUBSTANTIVE DISCUSSION OF THEIR DIFFERENCES. UNFORTUNATELY, THIS TIME-CONSUMING PROCESS IS EXTREMELY COSTLY. SPECULATION AGAINST THE ESCUDO HAS GROWN RAPIDLY, AS SHOWN BY THE RISE OF THE PARRALLEL RATE TO OVER ESCUDO 48/DOLLAR, AND WILL LIKELY CONTINUE TO INCREASE UNTIL A FUND AGREEMENT IS CONCLUDED. ONE CANNOT HELP BUT QUESTION WHETHER THE GOP AND IMF WOULD NOT BE WELL ADVISED TO CONCLUDE AN AGREEMENT PROMPTLY BY COMPROMISING THEIR DIFFERENCES. IF THEY DO NOT, THE EXCHANGE LOSS MAY BECOME EXTREMELY LARGE, ADDING AN ADDITIONAL HEAVY IMPEDIMENT TO EVENTUAL ECONOMIC RECOVERY.

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## Message Attributes

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